

COMMENTARY

# MONETARY AND FISCAL POLICY REDUX—THE MINI-BUDGET

Jagjit S. Chadha

National Institute of Economic and Social Research, London, UK

Not so very long ago, I argued that it was possible to characterise modern monetary and fiscal policy in the UK as a function of three key events: exit from the European Exchange Rate Mechanism in September 1992, the election of ‘New Labour’ in May 1997 and the global financial crisis of 2007–2009. The first led to the adoption of a domestic inflation target in October 1992, the second to the operational independence of the Bank of England and the establishment of the Monetary Policy Committee and the third to the acceptance of the need for macro-prudential policies, extraordinary monetary interventions to augment a simple interest rate rule and formal budgetary oversight by a fiscal council. The latter was provided by the Office for Budget Responsibility, which was established in 2010.

It was a journey that we thought complete.<sup>1</sup> But the events around the Truss–Kwarteng Mini-Budget of 23 September 2022 now add a fourth key date and have exposed so very clearly the ability of politics to disrupt the best-laid plans of any monetary-fiscal programme. Indeed, that ‘special fiscal operation’ will, I think, make it nearly impossible for any future government to work on a ‘fiscal event’ without showing its working and having that assessed by both the fiscal council and the monetary policy committee, unless it is prepared to pay a huge risk premium for any perceived or real divergence from a narrow orthodoxy.

## 1. Objectives

The challenge to the monetary-fiscal programme by the Truss–Kwarteng plan was threefold. First, shortly after his appointment on 6 September, the Chancellor announced a growth target of 2.5 per cent per year.<sup>2</sup> Although consistent with the post-WW2 average, this was significantly above current estimates of the trend growth rate, felt to be in the order of something like 1.5 per cent (or even less) per year. Second, there had been a sustained attack on the UK’s independent economic institutions. Finally, the Mini-Budget on 23 September not only introduced a large-scale cut in taxes, but also a commitment to higher levels of expenditure with an extended energy price guarantee for 2 years—there was also a promise 2 days later, on 25 September, of ‘more to come’.<sup>3</sup> The setting of unrealistic targets, cavalier use of fiscal instruments and a ‘disruptive’ mindset posed a disturbing question to the financial markets.<sup>4</sup> To some extent, the IMF provided its reply on 28 September by warning that the budget would increase inequality and counteract the Bank of England’s attempt to control inflation.<sup>5</sup> In other words, it would work against the orthodox aims of fiscal policy. My own letter to the Treasury Committee (Chadha, 2022b) went further: The subsequent turmoil in the financial markets, which on the Friday

<sup>1</sup>See Chadha (2019) in Barwell and Chadha (eds.) (2019).

<sup>2</sup>See the HM Treasury site at <https://www.gov.uk/government/news/chancellor-kwasi-kwarteng-sets-out-economic-priorities-in-first-meeting-with-market-leaders> (published on 7 September 2022).

<sup>3</sup>For the full text of The Growth Plan as delivered, see <https://www.gov.uk/government/speeches/the-growth-plan-2022-speech>. The statement about ‘more to come’ was made on the BBC at an interview on Sunday, 25 September (see <https://www.bbc.co.uk/news/live/uk-62995546/page/3>).

<sup>4</sup>One example of the kind of interview being given was summarised in Bloomberg on 5 September, ‘With the Economy in Trouble, the UK Gets “Disruptor-in-Chief,” as Leader’.

<sup>5</sup>The report from Sky News on 28 September is one example of many reporting the IMF warning, <https://news.sky.com/story/imf-warns-uk-against-mini-budget-that-will-likely-increase-inequality-12706612>.

alone led to a fall in the sterling–dollar exchange rate by some 2 per cent, equities by a similar amount and bond yields at 2 and 10 years jumping by over 40 bp and nearly 30 bp, respectively, was not only a function of the policy announcements, but also resulted from questioning the sense of a clear departure from the modern practices of accountability and transparency in policymaking.

Our own view was that in a world of interest rate normalisation in heavily indebted economies, it is a delicate matter to design an appropriate fiscal policy—one that cushions shocks for those least able to bear their brunt, but also provides sufficiently clear guidance on the likely path of future deficits, and therefore of funding requirements. The global market backdrop of rising interest expectations and a strong dollar was probably about as un conducive to the success of the new government’s strategy as might be imagined. And, this was not helped by the UK being a very open economy with a chronic tendency to over-consume and be reliant on the ‘kindness of strangers’ to fund our twin deficits; indeed, just before the COVID crisis, our net international investment position showed a net liability of some 30 per cent of GDP.<sup>6</sup> Under such circumstances, the typical approach of the G20 countries is not to stand out from the crowd and provide a focal point for the financial markets. The deployment of the Mini-Budget provided an object lesson in just how not to do it.<sup>7</sup>

## 2. The Fiscal Event

That we need to raise economic growth seems to have become the new economic objective, or even mantra. The secular decline in the growth of our productive capacity after the global financial crisis relative to our post-war economic experience, and relative to our main advanced country comparators, has been termed the ‘productivity puzzle’. Prior to that, output per head tended to grow at some 2 per cent per year—though it must be said that this average was dominated by two spurts, first in the immediate period of post-war reconstruction, and then after the deregulation reforms of the 1980s.<sup>8</sup> Subsequently, output per head has grown at barely 0.5 per cent per year.

It is widely understood that there has been a productivity problem and, indeed, the persistent (and so far unfounded) optimism about an upturn in productivity is a key reason for the forecast errors of the OBR. This has meant that our ratio of public debt to GDP has simply not improved in the way we envisaged and hoped in the aftermath of the global financial crisis, as the denominator in the equation has remained stubbornly stuck. The collection of shocks, with the scarring as a result of the financial crisis, the outcome of the Brexit referendum, COVID and supply chain disruptions, has sequentially restricted potential supply. Indeed, on 2 February 2023, the Bank of England’s Monetary Policy Report downgraded its view of potential annual productivity growth to around 0.5–0.6 per cent. It is though also widely understood that improving performance will require nurturing over time, with no quick fixes available in the public policy toolkit.<sup>9</sup> In fact, the policies that may best bring that about have been prevented by the short-termist politics of hitting short-run targets for the ratio of debt to GDP, and the consequent and ongoing squeeze on public investment.

The relationship with our main economic institutions was far from smooth. The permanent secretary of the Treasury, Tom Scholar, left on 9 September after 6 years, saying the incoming Chancellor Kwasi Kwarteng wanted ‘new leadership’. Earlier in the year, his number two, Charles Roxburgh, had already departed. His replacement, James Bowler, was not appointed until 10 October. Prior to that, the Bank of England had been vigorously criticised by MPs close to the new government for underestimating the threat of inflation.<sup>10</sup> And, while the OBR stood ready to provide ‘the most complete and up-to-date

<sup>6</sup>See the most recent release from the ONS, dated 27 April 2020, <https://www.ons.gov.uk/economy/nationalaccounts/uksectoraccounts/articles/understandingtheuksnetinternationalinvestmentposition/2020-04-27>.

<sup>7</sup>See J. S. Chadha in *Prospect* on 2 November: Truss’s implosion will make sound money a priority for the next generation of politicians.

<sup>8</sup>See Crafts (2019) on this issue.

<sup>9</sup>See Chadha and Samiri (2022).

<sup>10</sup>One example is from the *Financial Times* on 17 July 2022, Truss attacks Bank of England’s failure to tackle inflation, <https://www.ft.com/content/13422933-4829-453a-891a-26ffd8359c6b>.

picture of the economic and fiscal outlook as possible', it was not wanted by the new government.<sup>11</sup> Indeed, it was also reported that the Bank of England did not have its usual briefing prior to this fiscal event with neither the MPC nor the FPC given notice or the chance to advise the Chancellor on likely market reaction.<sup>12</sup> On the same day as these reports leaked, the government announced the creation of an Economic Advisory Council which comprised four economists familiar with financial markets.<sup>13</sup> While we accept the logic of democratically determined policy, it cannot operate best when frictions wear down the traction of independent advice.

Although it is quite likely that loose monetary policy globally had played a role in the inflation surge, the predominant factor in high inflation has been the huge escalation in energy and food prices in the aftermath of the Russian invasion of Ukraine. The thrust of the political gauntlet thrown at the Bank of England acted to divert some attention away from the need for the government to provide prompt financial support to poorer households. Political misdirection, as we have seen elsewhere in the world, may act to undermine the operational independence of central banks. The subsequent announcement on 5 January 2023 of the new government, wishing to halve inflation this calendar year, dilutes the Bank's responsibility and accountability for inflation.<sup>14</sup>

### 3. Conflict

#### 3.1. Co-operation or conflict

The maintained model of co-operation between the monetary and fiscal authority is illustrated in figure 1.<sup>15</sup> We draw two lines—first, one for the monetary policy response to a given fiscal surplus. As fiscal policy becomes looser, policy rates creep up. The other line is for the fiscal policy response to a given policy rate, and for higher policy rates, fiscal policy tends to be looser.

We assume that the preferences for the monetary policymaker and fiscal policymaker are similar with *bliss points* not far from each other. But let us allow for some slight difference in preferences, so that the monetary policymaker would like a slightly higher interest rate and higher fiscal surplus than the fiscal policymaker. We can then draw concentric circles or ellipses around each bliss point and join the bliss points to show the line along which they may strike a bargain. Under some form of co-operation, underpinned by institutional design, we will have interest rates and fiscal plans consistent with price and debt stability and not too far from the preferred positions of the monetary and fiscal authorities.

If, though, the two authorities cannot agree, and the institutional binding breaks, we will tend to the point where the two lines cross. Here no one has the incentive to change their responses, but at this Nash equilibrium interest rates will be higher and the fiscal situation looser. This position is worse for society, given the preferences of the central bank and fiscal policymaker. Co-operation beats Nash, but it requires strong institutional binding, because, at the point of the co-operative bargain, monetary policymakers may still prefer slightly higher interest rates and fiscal policymakers slightly looser fiscal policy. It was possible to characterise our macroeconomic stabilisation policy in that co-operative space prior to the events of autumn 2022.

The approach of the Truss–Kwarteng administration implied little interest in co-operation, as existing economic institutions were viewed as the problem. So, in a first step, we will move from the original point of co-operation towards the Nash equilibrium, but note also that the policy objective was for sustained looser fiscal policy, which also implies a shift down in the fiscal policy reaction function.

<sup>11</sup>OBR letter to Treasury Committee, 26 August 2022, [https://obr.uk/docs/dlm\\_uploads/Letter\\_to\\_TSC\\_Potential\\_Emergency\\_Budget.pdf](https://obr.uk/docs/dlm_uploads/Letter_to_TSC_Potential_Emergency_Budget.pdf).

<sup>12</sup>See, for example, The Guardian on 17 October reported that Bank of England officials were excluded from mini-budget discussions.

<sup>13</sup>This was reported at <https://www.gov.uk/government/news/government-to-establish-expert-economic-advisory-council>.

<sup>14</sup>See the five priorities outlined on 4 January 2023, <https://www.gov.uk/government/news/prime-minister-outlines-his-five-key-priorities-for-2023> and Chadha (2022a).

<sup>15</sup>Chadha and Nolan (2007) explore these interactions in a dynamic general equilibrium model.

### Institutional Design

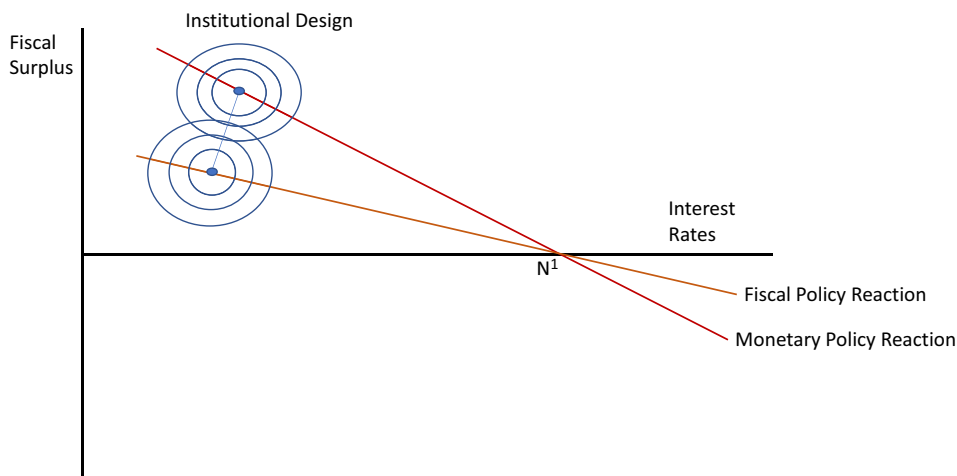


Figure 1. Institutional design

### Disruption

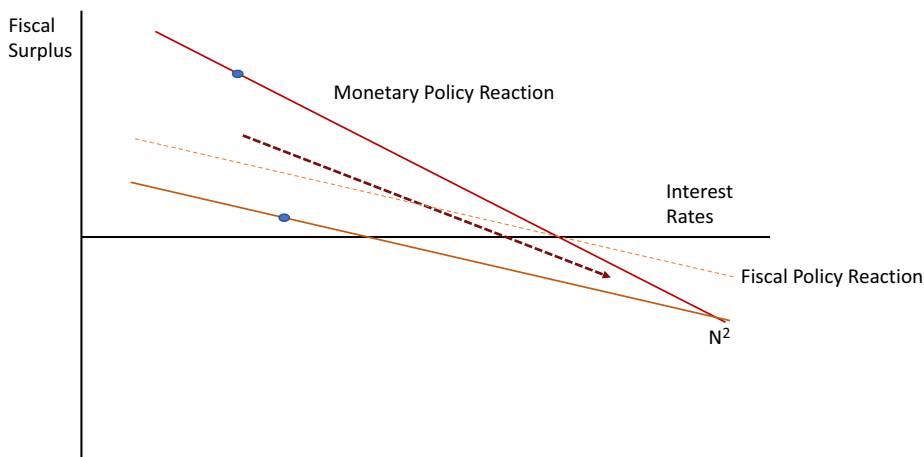


Figure 2. Disruption

This shift will amplify the size of the shock to policy rates and to the expected sequence of fiscal deficits (see figure 2). And, it was this sequence that formed our expectation when we modelled the Mini-Budget on 23 September (NIESR, 2022a, 2022b) and thought again about its impact the following week in our evidence to the Treasury Committee (Chadha, 2022b).

The commitment to an unfunded energy price guarantee and a slew of tax cuts announced by Chancellor Kwarteng on 23 September promised to inject demand into an inflationary economy. NIESR calculated this was something in the region of some 2–3 per cent of GDP in the first year, potentially raising output growth from –1 per cent to 2 per cent. This potential boost to demand served to trigger a rapid upwards revision in the path of Bank Rate, from a peak in the range of 3–4 per cent to over 6 per cent. We did not see the policies as likely to increase trend or potential growth but ones that would provide a temporary boost to output and increase the probability of a subsequent recession. It looked much more like the return of the ‘political business cycle’, see Treasury Committee (2022).

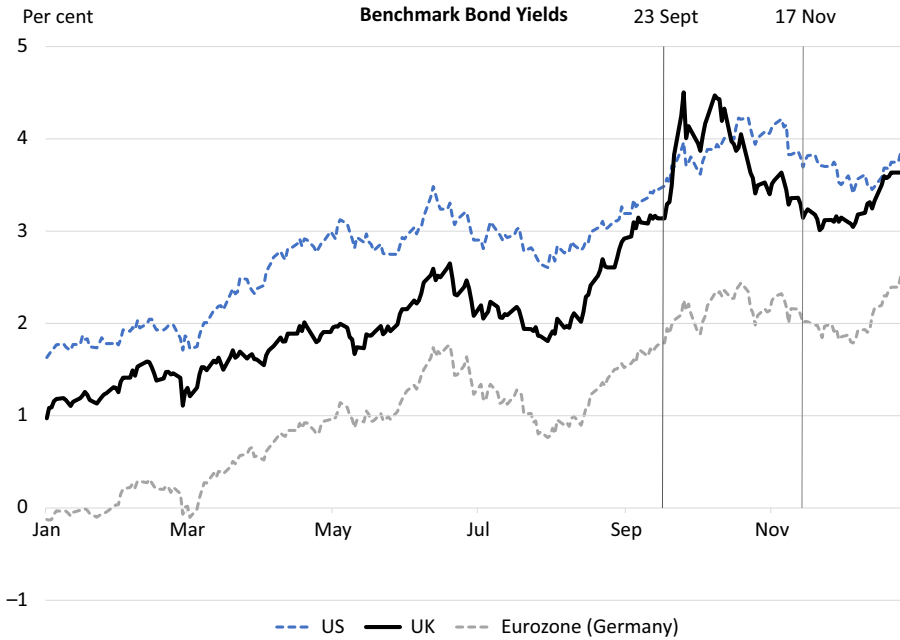


Figure 3. Benchmark bonds yields 2022

Such a large and rapid change in short interest rate expectations triggered a large fall in gilt prices and other financial prices (see figure 3). Cunliffe (2022) outlined the impact on the pensions industry, in which government bonds were used as collateral to leverage higher returns in the low interest rate regime, where the rapid fall in bond prices required the Bank of England to step in as market maker of last resort. Financial markets believed that if there was going to be a non-cooperative game between the central bank and the Treasury, in which the sequence of debts was going to be higher, then so would the sequence of interest rates. Such a squeeze was clearly untenable. As a side point, there was much concurrent discussion of whether ‘fiscal dominance’ would be at play, which is a world where the Bank of England would be unable to raise interest rates in order to combat inflation. But to the extent that market expectations of Bank Rate rose so rapidly, and so far, this would suggest that it was more obviously a case of monetary dominance (see figure 4) demanding a return to a more co-operative space.

While it is possible to argue that the fiscal problem had been less about budgetary objectives *per se* but more about the balance between tax increases and spending cuts, and prioritisation within spending which has both hit the poor and resulted in less public investment, it is our contention that working with economic institutions whose targets are well defined and which have instrument control can, under co-operation, lead to a significantly better outcome and more freedom to pursue underlying policy objectives.

#### 4. Concluding remarks

The shocks of the past few years, with Brexit followed by COVID and then supply chain and energy price shocks, have exposed the limitations of economic policy, in particular fiscal policy. The decline in trade intensity, dislocation in the labour market and a sharp fall in investment have all acted to crimp the supply side. And, this is the root cause of the structural fiscal deficit, as many workers are now increasingly reliant on forms of state support at a time when public services are in high demand.

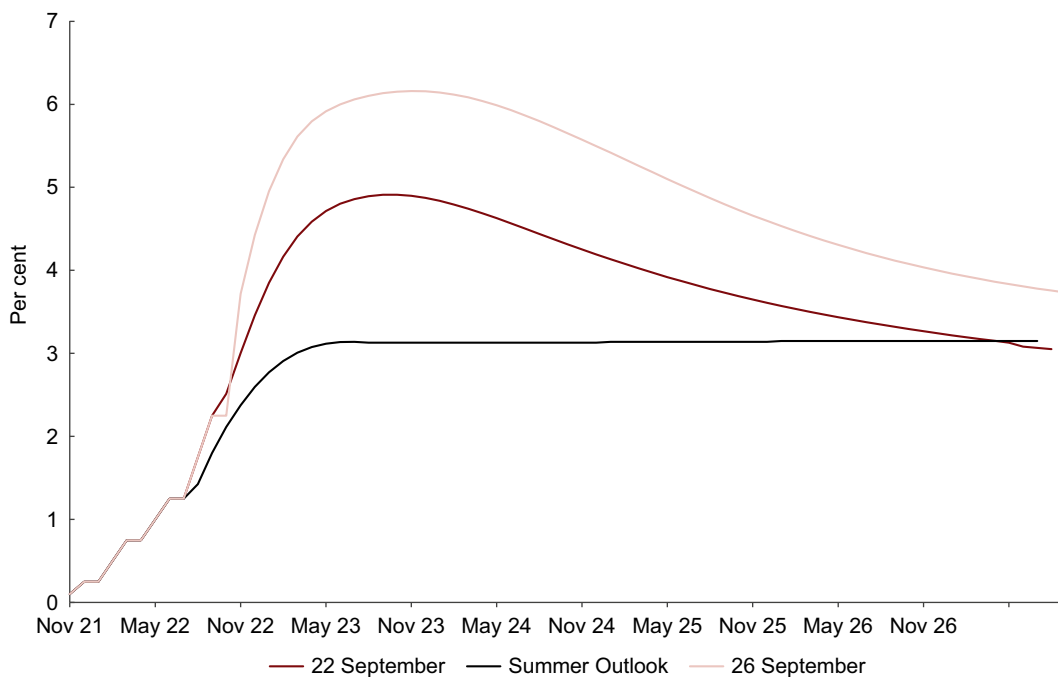


Figure 4. Bank rate expectations

This increase in the structural deficit has been addressed by seeking to reduce government consumption and investment, with deflationary fiscal rules. The repair operation mounted by the incoming Chancellor, Jeremy Hunt, at the Autumn Statement of 17 November was as welcome as it was necessary, but fiscal policy subsequently had to be tighter than it might otherwise have been had the Truss-Kwarteng plan never been implemented, in order to restore credibility. And, so we are in danger of repeating the same sequence of errors. Because productivity has persistently surprised on the downside, we have been unable to meet our fiscal targets.

Admittedly, the observed problem has been poor productivity growth, and while a different form of fiscal policy is part of the solution, it cannot be the whole answer, as any magical jump to a new higher growth path is not possible. The public sector needs to be slowly nurtured back to health, and revenues will need to be raised eventually to deal with the emergence of a structural deficit. This will mean that the link between public good and private benefits needs to be established empirically, and more convincingly than it was in 2010. In all of this, and while we try to move on, economic policy when coordinated will ultimately allow politicians more room, and not less, to engineer better growth outcomes.

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